EXAM No. _______

CONTRACTS EXAM

Professor Hadfield Fall 2007

December 14, 2007

Three (3) Hours, open book

INSTRUCTIONS

This is a three-hour open-book exam. You may use any books or materials you wish except that you may not submit any prepared notes or rough notes with your answer. You may not discuss cases, sections of the UCC or the Restatement that were not on the syllabus. You will have one hour to read the exam and think about your answer, making rough notes if you wish. During that hour you may not, however, write in your blue book or work on your computer. After the hour is over, you may begin composing your answer. The total number of points for this exam is 100 and your answer must consist of two parts. In the first part, you will <u>outline</u> the <u>legal</u> issues you identify in the fact scenario. You should break major issues into <u>related</u> sub-issues as much as you see you fit. If you have a factual question please note that explicitly. You should cite a case (briefly, just by name), Restatement or UCC section if that is necessary to make clear the legal basis for an issue you are raising; there is no need to cite any cases, Restatement or UCC sections for basic propositions about contract law. Do not include any analysis of the issues you identify in the outline. The issue spotting outline is worth <u>50 points</u>. When you are finished with your outline, you must choose one issue that you judge to be <u>important</u> to the advice you are asked to give in the problem. This issue may involve sub-issues. Your choice of what issue to write about is worth <u>20 points</u>. There is no need to explain or justify your choice of issue. You must then analyze that issue in depth and reach a final assessment of the strength of your client's legal position with respect to <u>that issue only</u>. Your analysis is worth <u>30 points</u>. In the event you change your mind about what issue to write about after you begin your analysis, <u>do not change issues</u>. Instead, you should explain at the end of your analysis why your judgment has changed and what other issue you would have written on had you recognized this sooner in the exam. I will take your explanation and proposal for an alternative issue for analysis into account when awarding points for the choice of issue. As a guideline, I suggest you spend <u>equal time</u> on the issue spotting section and the analysis section of the exam.
Good luck!

YOU MUST STOP WRITING WHEN INSTRUCTED TO DO SO BY THE PROCTOR. FAILURE TO DO SO WILL BE CONSIDERED A BREACH OF ACADEMIC DUTY AND WILL BE REPORTED TO THE DEAN'S OFFICE BY THE PROCTOR.

DO NOT LIFT THIS COVER SHEET UNTIL INSTRUCTED TO DO SO BY THE PROCTOR.

See last page for glossary of terms, contract terms and calculations of mortgage payments.

Maggie Montrose owns a horse farm in the San Gabriel Mountains. An avid horsewoman since she was a child, Maggie boards and trains horses and, with her staff, teaches riding and offers guided trail rides. Maggie owns 35 horses, boards another 25 and knows each one like she knows her own family members.

Five years ago Maggie took out a mortgage on her farm—which she had originally inherited from her grandfather—in order to undertake substantial upgrades and expand the facility from its original 30 horse capacity to accommodate up to 60 horses. She obtained this mortgage by visiting her local bank, San Gabriel Savings and Loan (SG S&L), where she spoke with her long-time banker, Sid Thoms. Sid proposed an adjustable rate mortgage for a $2 million loan with a low introductory rate of 3% for the first five years; after that the interest rate would adjust every month to be equal to the current prime rate plus 1%. Maggie told him about her worry that she might be overextending herself given that there were some risks involved: if she didn't get enough new business or if there was an outbreak of a virus among the horses that required her to close down under quarantine for a period (this had happened to her grandfather), she wouldn't be able to keep up with the mortgage payments. Sid suggested that they include a 'right of suspension' clause in the mortgage, which, he explained, would give her the option to suspend payments for up to six months in the event that she ran into financial difficulties like the ones she had mentioned. Maggie agreed and signed the mortgage documents. (*See last page for clauses.)*

Since taking out this mortgage, Maggie's business has had its ups and downs. She takes in revenues of about $50,000 a month on average with costs of $35,000 a month, leaving her $15,000 for her mortgage and all other living expenses. She has fallen behind on her payments a number of times, never by more than two months; each time she has called up Sid Thoms, explained the situation (unexpected cancellation of several boarding contracts, two short-term virus scares, problems in generating business after she fired her sales agent, etc.) Each time she has been able to scrounge up enough to pay what she owes. Sid has never mentioned any risk of foreclosure and neither has referred specifically to the suspension rights in the mortgage documents. She just calls and he says 'No problem Maggie, I'm sure you'll turn it around.'

A few months ago, Sid Thoms retired and was replaced by Radhika Marx. Radhika is one of a new breed of aggressive and effective bankers. SG S&L hired her just as the sub-prime mortgage crisis began to rock the banking industry, having heard from her previous employer that "Radhika knows where the bodies are buried and she gets the job done—let's just say I'd never want to be looking down the desk at her if I were ever a deadbeat borrower."

When Radhika arrived at SG S&L she began reviewing all of the files on outstanding mortgages. She was appalled. The bank had thousands of outstanding loans of the type that have sent the mortgage industry into a spiral: adjustable rate loans made at unrealistically low introductory rates to people who could not afford the loans once the rates adjusted to higher rates. Radhika advised SG that it should immediately foreclose on all loans that are in default so they can resell the properties before the housing market crashes. The SG executives are distressed by this advice—they know the bank is in serious financial difficulty, but this approach seems to them overly harsh and unfair. Instead, they compose a letter to all borrowers, discussing the sub-prime mortgage crisis and the risks this has created that interest rates will increase substantially, home prices will fall significantly, and many borrowers will find themselves in default. The letter states that SG S&L "strongly encourages you to contact us to discuss the terms of your loan and the benefits of converting your existing loan to one that reduces your risk of default. For the next thirty days, we are offering to convert all existing adjustable rate mortgages to fixed rate mortgages at 6% with no prepayment penalties." This letter was mailed to all borrowers on November 10; Maggie received her copy on November 12. Maggie gave some thought to the option of converting to a fixed rate mortgage but threw the letter away. She doesn't pay much attention to the financial news and doesn't think that interest rates will go up.

Radhika was disgusted by the weak action taken by the 'lily-livered' executives at SG S&L and began reviewing files again to identify loans on which she felt she should take independent action. Among the loans that caught her attention was Maggie Montrose's. She noted that Maggie had been in default several times over the past five years, and was 40 days late on last month's payment. Radhika reviewed the notes Sid had scribbled on the file: "quarantine" "virus" "sales rep fired" "boarding contracts cancelled." "What hogwash" she thought. Radhika put in an immediate call to Maggie, leaving a voice mail message: "Ms. Montrose, this is Radhika Marx of San Gabriel Savings and Loan. Today is the 20th of November. I am the bank officer in charge of your mortgage and you are currently in default. You need to contact me immediately or I will be filing papers to begin foreclosure on your property."

Maggie was stunned to receive the voicemail later that day. She called Radhika who told her that she should come in immediately. Maggie grabbed her somewhat haphazard business files and jumped in her truck. As she drove to the bank, she reviewed the problems the business had faced in the last few months: first the recent fires that had shut down access to the farm for a few weeks and then an expensive illness that had hit half of the horses and led many boarders to cancel. She rehearsed how she would explain the situation to Ms. Marx and why she thought she'd be back on track in a few months when her regular boarders returned.

When she arrived at the bank, Radhika was sitting at her desk, which was empty except for a copy of Maggie's mortgage agreement, a draft of a new agreement, an official looking document titled "Petition for Foreclosure," and a printout from an internet newsletter for the mortgage industry with a bold-faced headline "PRIME PREDICTED TO HIT 8% BY YEAR'S END." It was this article, which Radhika read a month ago, that galvanized her into action. She knew that if the prime went to 8%, thousands of her adjustable rate mortgage customers would be completely unable to make their payments, now or ever. Radhika's main goal was to get the adjustable rate mortgages off the books as quickly as possible, making her a star at SG S&L.

Maggie started to explain the troubles the farm had been having lately, pulling out papers that documented these difficulties and putting them on the desk in front of Radhika. Radhika interrupted Maggie after several minutes. "Ms. Montrose. I really don't care about your problems. I'm a banker not a social worker. You are in default. That's simply not subject to dispute. We have the right to foreclose and we intend to foreclose." She waved the document that said "Petition to Foreclose" and continued "I have the paperwork ready, right here and I intend to file this with the court tomorrow unless we reach an agreement today. Here is what I am proposing. It is clear you are completely over-extended and this business of yours is a disaster. You need to sell off half the property, including at least 15 horses. Sign here: this document says you agree to transfer to us the right to put the western half of your property up for sale and to keep up to $1 million of the proceeds from the sale of the property and the horses. You will owe a $50,000 prepayment penalty, 5% of the amount being pre-paid, which is $1 million. We will then pay off your old mortgage and issue a new mortgage for $1 million at a fixed rate of 6%."

Maggie was stunned. "You've got to be kidding. Sid and I were always able to work this out. He promised me when we did this mortgage, that I'd have the ability to suspend my payments if I got into a tight spot. I'm sure it's in the papers somewhere. You can't do this." Radhika responded "I don't give a hoot about your supposed suspension rights. I saw that in there and it's just another example of how Sid Thoms damaged this bank. We are not going to honor such a mindless clause. You can try and fight it but that's going to take months and thousands of dollars in legal fees. Do you realize that your payments are soon going to hit 9%?" She handed Maggie the internet newsletter. "9%!" Maggie exclaimed, "I'll be bankrupt in a few months! I'd lose the farm! The horses!" "This bank is doing everything it can to help you Ms. Montrose, " Radhika replied, "but frankly I don't care one way or the other what happens to you or your horses. Not my problem. My problem is getting this bank into financial shape and that means you either agree or we foreclose. Here are the documents. Sign them and drop them off by 9 am when the bank opens in the morning otherwise I'm filing for foreclosure at 10 am. And here, take this mess of papers back—I'm really not interested in your rather pathetic efforts to show how hard you've been trying or how hard things are for you. Sid may have been interested but I'm not. Good day m'am."

Maggie left in tears with the new documents. When she got home, she remembered the letter she had received from the bank. She called Radhika and told her she wanted to restructure her loan as proposed in the letter without prepayment penalties. Radhika responded, "Ms. Montrose, we have already discussed your situation, I have made you a proposal and that offer is no longer open to you." Maggie got off the phone and went down to talk to her stable manager, Zeus, who reminded her that they had both projected significant growth in the business in the coming year because of the closure of some key competitors; the recent fires and illness had just slowed them down a few months in achieving that potential. "But," Maggie told him, "that doesn't matter now because if I have to start paying 9% interest I'll be bankrupt in months." She signed the papers and delivered them to the bank in the morning. Furious about what had happened, and to get back at SG S&L, she sold off 15 of her horses in the next few days at give-away prices of $1000 each. The horses are usually worth about $10,000 each.

That was almost a month ago. In the interim, the bank has listed half of the property for $1 million but it has not yet sold. Also in the interim, the internet newsletter that Radhika showed Maggie has been exposed as the work of two high school students in a garage. No-one has been or is now predicting the prime rate to go above 5% in the foreseeable future. And Maggie has learned that one of the horses she sold was quickly resold as a potential racehorse for $100,000. Others, to Maggie's great distress, were resold to butchers as meat. Please advise Maggie on her legal options. You should assume that at all times both Sid and Radhika are acting as authorized agents of the bank (so ignore, had they occurred to you, any problems of agency) and that yes, Radhika sincerely believed the internet newsletter was accurate.

Some clauses in the original mortgage agreement:

Right of suspension: Borrower shall take all reasonable steps to remain in good standing on this loan obligation. However, in exceptional circumstances, Borrower shall have the right, upon provision of notice and documentation sufficient to satisfy Lender as to Borrower's efforts to remain in good standing and the exceptionality of circumstances, to suspend payments for a maximum of six (6) months.

Right of foreclosure: In the event Borrower is more than 30 days past due on any payment, Lender shall have the right to immediately foreclose on this loan and retain any proceeds from a sale of the property sufficient to repay the principal and accumulated interest owing.

Prepayment: Borrower may prepay amounts to reduce the principal on this loan for a penalty of 5% of the amount Borrower seeks to prepay.

Entire agreement: This Agreement contains the entire Agreement between Lender and Borrower.

Glossary of terms:

Mortgage: A mortgage is a loan which is gives the lender a right of foreclosure.

Foreclosure: A right of foreclosure entitles the lender to take possession of the property and put it up for sale if the borrower fails to make his or her mortgage payments. The lender keeps all of the money from the sale.

Principal: The principal is the amount that is borrowed.

Prime rate: The prime rate is the rate at which banks lend to their best customers. It is published every week in the Wall Street Journal.

Mortgage payments

Assume that the monthly cost for a mortgage of **$2,000,000** is:

3%	$8,000
6%	$12,000
9%	$16,000

Assume the monthly cost for a mortgage of **$1,000,000**

6%	$6,000